

Controller *John Chiang*

California State Controller's Office



September 2008 Summary Analysis

Volume 2, Issue 9

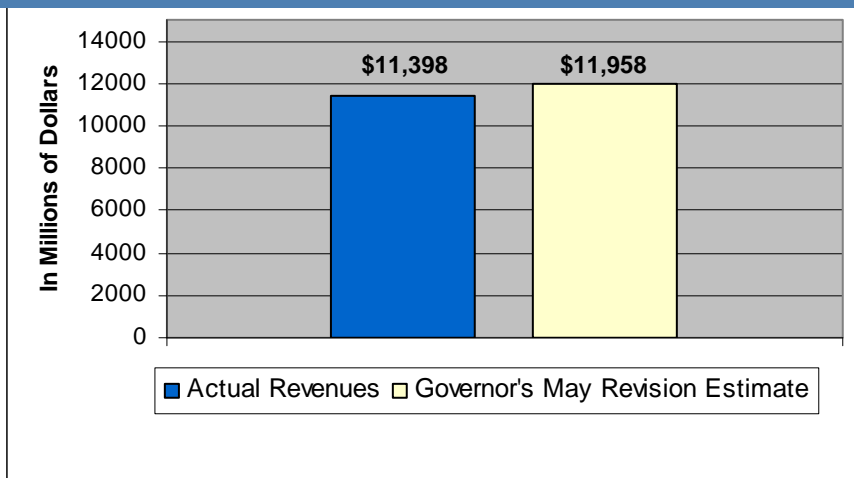
Statement of General Fund Cash Receipts and Disbursements

Revenue in August 2008

- ⇒ In August 2008, General Fund revenue was \$505 million below (-6.9%) the Governor's May Revision estimate for the month. Retail sales tax receipts accounted for most of the loss, coming in \$335 million below (-9.3%) estimate. Personal income taxes were \$79 million below estimate (-2.6%) while corporation taxes were above estimate by \$41 million (24.8%). Together the three largest taxes (income, sales, and corporate) were \$372 million below (-5.5%) the May Revision estimate. Insurance taxes were below estimate by \$299 million (-77.0%), but higher than average receipts in the first few days of September indicate that the August decline was likely a timing issue.
- ⇒ Compared to August 2007, General Fund revenue in August 2008 was lower by \$228 million (-3.2%). Retail sales taxes were below last year's receipts by \$325 million (-9.1%) and personal income taxes were below August 2007 by \$89 million (-2.9%). Corporation taxes were up by \$47 million (29.4%).
- ⇒ The total for the three largest taxes was below 2007 levels by

(Continued on page 2)

Table 1: General Fund Revenues: July 1, 2008–August 31, 2008 (in Millions)



The State Controller's Office is responsible for accounting for all State revenues and receipts and for making disbursements from the State's funds. The Controller also is required to issue a report on the State's actual cash balance by the 10th of each month.

As a supplement to the monthly *Statement of General Fund Cash Receipts and Disbursements*, the Controller issues this Summary Analysis for California policymakers and taxpayers to provide context for viewing the most current financial information on the State's fiscal condition.

This Summary Analysis covers actual receipts and disbursements for August 2008, and cumulative for the first two months of Fiscal Year 2008-09. Data are shown for total cash receipts and disbursements, the three largest categories of revenues (personal income, corporate and sales taxes), and the two largest categories of expenditures (local assistance and state operations). This report also provides the State's latest revenue projections as points of comparison. Since the State does not yet have an approved budget for 2008-09, the estimates contained in the Governor's May Budget Revision are the most recent available projections.

(Continued from page 1)

\$366 million (-5.4%). Payroll withholding taxes, the primary component of income taxes in August, were \$40 million lower (-1.4%) compared to August of last year.

Tax Revenue Fiscal Year to Date

⇒ For the first two months of the fiscal year revenue is \$560 million below (-4.7%) the May Revision estimate. Retail sales led the decline by dropping \$466 million below (-10.1%) the year-to-date estimate. Corporate taxes were below estimate by \$4 million (-0.9%) while income taxes were above estimate by \$144 million (2.5%). The three major taxes are collectively \$326 million below (-3.0%) estimate for the first two months of the fiscal year. Insurance receipts were below estimate by \$286 million (-71%) but as noted above, some of the shortfall in insurance receipts will probably be captured in September.

⇒ Compared to this date in August 2007, revenue totals are \$227 million higher (2.0%). This improvement was due to a \$637 million increase in the “Not Otherwise Classified” category, which includes abandoned property collections. Those collections were virtually halted last summer as new rules for locating owners were instituted.

⇒ Year-to-date collections for the three major taxes are \$388 million below (-3.6%) last year at this time. Retail sales has the largest shortfall, \$331 million below (-7.4%) last year at this date. Corporate taxes are \$36 million below (-8.0%) last year, and personal income taxes are \$20 million below (-0.3%) last year at this date.

⇒ Despite the weak showing for August, withholding taxes are still slightly ahead of last year (\$68 million) on a year-to-date comparison. Employment is continuing to decline in California, which saw a loss of 54,200 jobs in the first seven months of the year. The August employment report for the nation showed 84,000 jobs lost, indicating further possible job losses in the California labor market in August. These trends indicate that the weakness in withholding may continue. Estimated income taxes for July and August are slightly ahead (\$16 million) of last year, but September’s quarterly estimated tax payments will provide a better idea of the direction estimated payments are headed.

⇒ Quarterly estimated corporate taxes are also due in September. Estimated corporate taxes through August are \$66 million behind last fiscal year at the same time.

Table 2: General Fund Receipts, July 1, 2008-August 31, 2008 (in Millions)

Revenue Source	Actual Receipts To Date	May Revision Budget Estimate	Actual Over (Under) Estimate
Bank And Corporation Tax	\$417	\$421	(\$4)
Personal Income Tax	\$5,850	\$5,706	\$144
Retail Sales and Use Tax	\$4,137	\$4,603	(\$466)
Other Revenues	\$994	\$1,228	(\$234)
Total General Fund Revenue	\$11,398	\$11,958	(\$560)
Non-Revenue	\$331	\$187	\$144
Total General Fund Receipts	\$11,730	\$12,145	(\$415)

Note: Some totals on charts may not add, due to rounding

(Continued on page 3)

(Continued from page 2)

Summary of Net Cash Position as of August 31, 2008

- ⇒ Through August, the State had total receipts of \$11.7 billion (Table 2) and disbursements of \$15.9 billion (Table 4). The deficit of \$4.2 billion was covered by internal borrowing.
- ⇒ Of the largest expenditures, \$9.3 billion went to local assistance and \$4.7 billion went to State operations (See Table 4).
- ⇒ Disbursements through August were \$1.8 billion lower (-10.3%) than estimated in the May Revision. The net savings is related to payments not made due to the lack of a budget. The \$3.4 billion smaller payment to local assistance is partially offset by a \$1 billion dollar advance to MediCal providers and \$300 million in other payments listed under NonGovernmental payments and contained in the “Other” category of Table 4.

(Continued on page 4)

Table 3: General Fund Cash Balance As of August 31, 2008 (in Millions)

	Actual Cash Balance	Governor's May Revision Budget Estimate	Actual Over (Under) Estimate
Beginning Cash Balance July 1, 2008	(\$1,452)	(\$4,799)	(\$3,347)
Receipts Over (Under) Disbursements to Date	(\$4,165)	(\$5,572)	\$1,407
Cash Balance August 31, 2008	(\$5,616)	(\$10,371)	\$4,755

Table 4: General Fund Disbursements, July 1, 2008-August 31, 2008 (in Millions)

Recipient	Actual Disbursement	May Revision Budget Estimate	Actual Over (Under) Estimate
Local Assistance	\$9,328	\$12,782	(\$3,453)
State Operations	\$4,744	\$4,666	\$78
Other	\$1,822	\$269	\$1,553
Total Disbursements	\$15,894	\$17,717	(\$1,823)

Estimated Taxes

Estimated tax payments are generally filed quarterly to pay taxes due on income not subject to withholding. This can include income from self-employment, interest, dividends, gains from asset sales, or if insufficient income tax is being withheld from a salary, pension, or other income.

Payroll Withholding Taxes

“Payroll Withholdings” are income taxes that employers send directly to the state on their employees’ behalf. Those amounts are withheld from paychecks during every pay period throughout the calendar year.

Economic Recovery Bonds

Voters approved \$15 billion in recovery bonds for State operations when they adopted Proposition 57 in 2004. The final \$3.3 billion were sold in February 2008 to cover projected shortfalls in future budget years.

Borrowable Resources

State law authorizes the General Fund to internally borrow on a short-term basis from specific funds, as needed.

(Continued from page 3)

⇒ The State ended last fiscal year with a net cash deficit of \$1.45 billion. That deficit was covered by internal borrowing. Last month's deficit of \$4.1 billion and this month's cash deficit of \$70 million are both covered by internal borrowing. Loans from internal sources now total \$6 billion. At the end of August, the State had \$9.9 billion remaining in cash and unused borrowable resources. Internal loans will be repaid according to cash management procedures as resources are available.

How to Subscribe to this Publication

This Statement of General Fund Cash Receipts and Disbursements for August 2008 is available on the State Controller's Web site at www.sco.ca.gov. To have the monthly financial statement and summary analysis e-mailed to you directly, sign up at www.sco.ca.gov/ard/cash/email-sub.shtml.

Any questions concerning this Summary Analysis may be directed to Hallye Jordan, Deputy Controller for Communications, at (916) 445-2636.

California Economic Snapshot		
Median Home Price (for Single Family Homes)	\$587,560 In July 2007	\$350,760 In July 2008
Single Family Home Sales (Seasonally Adjusted Annual Rate)	341,130 in July 2007	489,080 in July 2008
California Foreclosures Initiated (Notices of Default)	53,943 In 2nd Quarter 2007	121,341 In 2nd Quarter 2008
Total State Employment (Seasonally Adjusted)	15,192,700 in July 2007	15,116,800 in July 2008
Newly Permitted Residential Units (Seasonally adjusted Annual Rate)	109,400 in July 2007	57,000 in July 2008
Data Sources: California Association of REALTORS (sales data), DataQuick (foreclosure data), California Employment Development Department, Construction Industry Research Board		

California State Controller John Chiang:

300 Capitol Mall, Suite 1850
Sacramento, CA 95814

P.O. Box 942850
Sacramento, CA 94250

Telephone: (916) 445-2636

777 S. Figueroa Street, Suite 4800
Los Angeles, CA 90017

Telephone (213) 833-6010
Fax: (213) 833-6011

Fax: (916) 445-6379

Web: www.sco.ca.gov

Featured Articles on California's Economy

Controller John Chiang's Council of Economic Advisors informs the Controller on emerging strengths and vulnerabilities in California's economy, major issues and trends that may affect the State's fiscal health, and how to make the best use of limited government revenues and resources.

The advisors also contribute monthly articles on issues regarding California's economy. The opinions in the articles are presented in the spirit of spurring discussion and reflect those of the authors and not necessarily the Controller or his office. This month's report includes an article by Esmael Adibi Director, Anderson Center for Economic Research, Chapman University, and Member, Controller's Council of Economic Advisors.

Financial Markets: What Went Wrong and What's Next?

By Esmael Adibi
Director, Anderson Center for Economic Research,
Chapman University
Member, Controller's Council of Economic Advisors

The recent turmoil in the financial markets increased the chance that the U.S. economy is/ or will be in recession and the global economic growth will be sharply reduced. To understand the nature of the problem, let's recall the events that occurred over the 2001-06 period that led to the current situation.

After the dot-com collapse, sharp declines in stock prices, the recession of 2001 and 9-11, the Federal Reserve Board reduced the Federal Funds rate to 1.0 percent and in numerous public statements assured the investment community that they would not change the rate in the foreseeable future. Likewise, the Central Bank of Japan lowered its short-term interest rate to a quarter percent to stimulate ailing domestic demand. The investment community, including many hedge funds, took advantage of this opportunity by engaging in what is known as "carry trade." They borrowed funds at the near zero short-term rates and lent it at much higher long-term rates, pocketing

the spread with effectively no fear of losing money. This increased liquidity — coupled with the glut of savings from China and other Asian countries and substantially higher surplus revenue from oil producing countries — reduced long-term interest rates, including mortgage rates, to historical lows. With the stock market in the doldrums, the easy money seeking higher rates of return turned to real estate. The mortgage industry blossomed and in



order to increase the pool of potential borrowers, creative financing such as 100 percent loan to value, stated income mortgages known as Alt-A, interest

(Continued on page 6)

(Continued from page 5)

only loans, piggyback loans and negatively amortized loans (option-Arms) were marketed to not only potential homebuyers with good credit history but to subprime borrowers with much higher interest rates and hefty prepayment penalties. These creative financing schemes helped many to become homeowners. But some homebuyers totally ignored the affordability issue and bought homes that they could not have afforded based on their current and future expected income.

As long as home prices were appreciating and cheap and available financing were obtainable, all went well. When home prices began decreasing, speculators bailed out. Some who bet on higher prices and refinancing options when they bought homes in the past four years are simply walking away. Notices of defaults and foreclosures are increasing. The subprime mortgage industry disappeared. Banks, hedge funds and other financial institutions that are holding Mortgage Backed Securities (MBSs) or Collateralized Debt Obligations (CDOs) are losing money and in many cases cannot even price their holdings accurately. Even Fannie Mae and Freddie Mac, the backbone of the mortgage industry, are facing financial difficulties. These firms already own or guarantee 45 percent of all residential mortgages in the country, and since 2002, they became major buyers of adjustable-rate mortgages including risky Alt-A mortgages and interest only loans. Some \$300 billion in adjustable rate mortgages guaranteed by these agencies will automatically reset through 2011.

No question, the Fed is pulling out all the stops, having cut its discount rate by four percentage points to 2.25 percent. And while borrowing at the discount window carries a stigma of a struggling bank, in an unusual step, the Fed invited the banks to do more borrowing. It has reduced the federal funds rate from 5.25 percent last September to 2.0 percent. In addition, the Fed played "White Knight" with a \$30 billion "loan" to J.P. Morgan to acquire Bear Stearns. The Fed also supplied \$400 billion in liquidity to financial firms in need of capital to shore up their shaky

asset positions. In addition, investment houses can access Central bank for cash and can swap more risky investments for super-safe treasury securities. These programs were recently extended to January 30 of 2009.

On a separate move by Congress and the Treasury Department, FHA will insure up to \$300 billion in refinanced mortgages at up to 90 percent of a home's newly appraised value, as long as the lenders agree to write down the principal. This is an attempt by the government to slowdown foreclosures and to reduce the supply of homes for sale in order to stabilize home prices. With all that, banks are still tightening lending standards, pointing to the continuation of credit crunch conditions.

Financial institutions have so far taken \$400 billion in losses, and some estimates indicate that number could reach \$1 trillion. The "credit bubble" of the last few years and risky lending practices of investors that should have known better, has turned into a "credit bust." Risk aversion is the natural outcome of years of excessive risk-taking behavior and that aversion will be with us for some time. The lack of liquidity has spread from the mortgage market to all facets of lending.

Although our projections show that U.S. housing prices, on average, are nearing the bottom, the next few years will still be challenging for many financial institutions. More losses and more bank failures should be expected, and the tighter lending standards will remain intact for an extended period of time. As some may recall, tighter credit plagued the economy for three years after the 1989 collapse in junk bonds.

The aftermath of credit burst not only will affect Wall Street firms but weigh on other companies and consumers. And this, in turn, suggests that economic growth will be below the trend line over the next few years.